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RUEHPE/AMEMBASSY LIMA 391
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USDOC FOR 3134/ITA/USCS/OIO/WH/RD/SHUPKA

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TAGS: [ECON](#) [PGOV](#) [EFIN](#) [PREL](#) [SOCI](#) [BR](#)
SUBJECT: WHY BRAZIL'S ECONOMY WILL JUST KEEP MUDDLING THROUGH

REF: A) BRASILIA 2490
B) BRASILIA 2278
C) BRASILIA 2099
D) BRASILIA 1151

This cable is Sensitive But Unclassified, please protect accordingly.

1. (SBU) Summary: By many measures, Brazil's economy has better fundamentals today than it has had at any point over the last three decades. The 1994 "Plano Real" brought previously unknown macroeconomic stability to Brazil, defeating its traditional inflation nemesis. Fiscal management has produced solid results: the public sector routinely exceeds its primary surplus targets and debt levels are falling. An ongoing export boom underpins continued surpluses in Brazil's external accounts. But Brazilians are glum about growth, which has averaged about 2.5% over the last twelve years. Investment levels, currently about 20% of GDP, are simply insufficient to support higher growth. There is no shortage of reasons for this, ranging from Brazil's fiscal knot (ref A) to its high taxes and onerous tax compliance burden, infamous bureaucracy, lack of spending on research and development, infrastructure gap, low levels of human capital, questionable priorities in education spending, burgeoning social security deficit and burdensome labor regulations.

2. (SBU) Dealing with these will require a legion of reforms of significant scope. Brazil's political system and societal priorities, however, work to water down the ambition of attempts at reform. Society is firmly supportive of low inflation policies and fiscal responsibility, but has a knee-jerk reaction to talk of

(further) privatization. Meanwhile, Brazil's closet mercantilists in industry and the foreign ministry help keep the economy relatively closed, limiting the potential to increase productivity through greater openness to trade. Together, these factors mean that economic inefficiencies and low productivity growth will keep sustainable GDP growth in the 3% to 3.5% range well into the medium term. But neither is Brazil's economy headed for a crisis; it will just keep muddling through with middling performance. End Summary.

Macro vs. Micro

13. (SBU) It is worth reflecting on how far Brazil has come in the twelve years since the "Plano Real" was introduced in 1994. The plan defeated the hyperinflation of the 1980's and, through privatizations, placed much of the economy in private sector hands. The current macroeconomic policy mix of a floating exchange rate, inflation-targeting monetary policy and high primary fiscal surpluses -- necessary to bring down high debt levels -- was introduced in 1999 and has consolidated macroeconomic stability. Inflation should be less than 3% this year and is expected to be only 4% next year. Public debt levels are high (net debt of about 50% of GDP and gross debt of 72.1% of GDP) but strong primary surpluses have brought the ratio down each year since 2003; in 2005 Brazil prepaid its IMF debt, and followed that up by paying off its Brady bonds and Paris Club debt in 2006, both the legacy of its late 1980's debt default. Macroeconomic stability and privatization set the stage for the Brazilian companies to be able to take advantage of the current surge in world trade growth and the ensuing export boom has solidified Brazil's external accounts tremendously. Continued current account surpluses have allowed Brazil to pay down external debt. Given lower debt and Central Bank purchases of inflowing dollars, Brazil's public sector has become a net creditor to the rest of the world. Moreover, the ghost of hyperinflation

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past still lingers in Brazil, helping create a clear societal consensus in favor of low inflation and fiscal responsibility.

14. (SBU) But Brazilians now crave higher economic growth rates. These have averaged 2.7% over the four years of the Lula presidency, up from 2.2% over the eight years of the Cardoso presidency. The key issues in reaching this goal are productivity growth (how well one uses existing capital and labor) and investment levels (to build up more capital stock), neither of which has grown enough to create the capacity for Brazil's GDP to grow at the 5% level, a figure which some politicians are urging be adopted as a growth target. A recent study by the Applied Economic Research Institute (IPEA), an independent think-tank attached to the planning ministry, concluded that at current investment rates Brazil's capital stock would not attain those levels necessary to sustain 5% annual GDP growth until 2017.

15. (SBU) The current transition between Lula's first and second terms, and the renewal -- to an extent -- of his political mandate, has brought sharper political focus to the growth debate in recent weeks. Commentators, policy makers and policy wonks are flogging various programs to address this or that perceived limitation on growth. There also is public sparring between the "developmentalists" who favor large state-led development models, with the more orthodox economists who favor a focus on structural and microeconomic reforms as the mechanisms to increase investment.

Table - Savings, Investment and GDP Growth
(Percent of GDP)

Year	Domestic Savings	Gross Fixed Capital Formation	GDP Growth
2001	16.75%	19.47%	1.3%
2002	18.51%	18.32%	1.9%
2003	20.38%	17.78%	0.5%
2004	23.17%	19.58%	4.9%

2005	22.4%	19.93%	2.3%
2006	21.6% /1		2.9% /2

/1 January through March of 2006

/2 Predicted 2006 GDP growth

Fiscal Issues Are the Biggest Problems

¶6. (SBU) The economic distortions and other structural problems that reduce investment levels are legion. Foremost among these is Brazil's fiscal knot, described in detail in ref A. The need to service debt and finance a burgeoning social security deficit within the confines of a rigid constitutional earmarking and fiscal federalism framework has a three-fold effect: 1) Brazil has a high tax burden, approaching 40% of GDP; 2) its financing needs crowd out private investment; and, 3) the public sector makes only limited investments itself. The constitutional amendments necessary to begin to unravel the knot by reforming the social security system and Brazil's fiscal federalism framework require congressional super-majorities. According to published accounts, however, in his quest to bring in the leftist PDT party to his governing coalition, Lula may have promised to forego ambitious social security reform.

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¶7. (SBU) Many businesses find much of Brazil's physical infrastructure to be lacking. During its first term the Lula administration, acknowledging the fiscal constraints on government investment in infrastructure, touted public-private partnerships (PPPs) as the solution to unlocking private investment in marginally economical infrastructure projects. The Congress passed PPP legislation in December 2004, but the reality of the bureaucratic and substantive hurdles to issuing implementing regulations meant that despite the hype, the federal government did not put out for bid any PPP projects during Lula's first term. A few state governments have moved with greater alacrity. The PPP example is also a useful illustration of how slowly the Brazilian bureaucracy can move. Turf fights between the ministries, in addition to a lack of capacity to quickly hire consultants qualified to evaluate major projects, have contributed to the PPPs glacially slow roll-out.

¶8. (SBU) Brazil's infamously high real interest rates also come in for criticism as a factor limiting growth levels. Two key factors in this tale of high interest rates are judicial insecurity and the distortion of markets in savings and lending through directed credit mechanisms and mandatory savings schemes that direct capital to the national development bank (BNDES). The directed credit mechanisms require banks to loan a significant percentage of their deposits to agriculture at low real interest rates (about 5%). Workers also contribute to the FGTS, a mandatory savings for unemployment scheme, which finances the activities of the BNDES. As both the IMF and OECD have pointed out, these measures have the effect of increasing interest rates on all other lending as banks charge more on other loans to make up for cheap agricultural lending and must pay higher rates to compete for the pool of savings. Moreover, these distortions limit the financial intermediation role played by banks, which theoretically would route capital to its most efficient economic use.

¶9. (SBU) Brazil's judicial system is infamous for the unpredictability of its outcomes. Many analysts complain that judges, particularly in the lower courts, take "social equity" into account in rendering their decisions, making it difficult for a bank to collect on loans or a company to enforce a contract. A chief economist at a major Brazilian Bank told Econoff it could take as long as 10 years for his bank to use the judicial system to collect on a loan. The introduction of the concept of binding precedent in the 2004 judicial reforms will, over time, help to make the system more predictable. The courts also contribute to a general climate of regulatory uncertainty. Although the regulatory framework in many sectors is adequate, according to analysts, unpredictable enforcement and changes in the rules, such as Lula's 2004 overhaul of the power sector regulatory model, have hurt existing investors.

¶10. (SBU) Most employers find Brazilian labor laws very restrictive, creating significant and expensive compliance burdens and limiting the flexibility of businesses to work in new ways. Moreover, various payroll levies, such as social security and the FGTS unemployment insurance/mandatory savings scheme come close to doubling the cost of labor to the employer. Most economists believe reform of the outdated labor laws would help increase economic efficiency and make business more competitive. But labor reform would come only at great political cost for Lula, who requires support from both the left wing of his own PT and some of the smaller leftist parties to obtain congressional majorities.

No Societal Consensus Behind Micro Reforms

¶11. (SBU) In marked contrast to the consensus supporting low

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inflation and responsible fiscal policies, many deeper structural and microeconomic reforms are manifestly unpopular. In a telling moment in the recent presidential campaign, the Lula campaign accused pro-business PSDB party candidate Geraldo Alckmin of intending to privatize Brazil's remaining parastatals. Rather than defend the many palpable benefits that successful privatization already has brought to Brazil -- most obviously in the telecommunications sector, where privatization brought efficient and ubiquitous service at lower prices, in sharp contrast to the waiting lists and prohibitive pricing that previously prevailed -- the Alckmin camp issued denials that it had any intentions of pursuing privatization. Fortunately, parastatals such as Petrobras and Eletrobras already have been partially privatized (a fact many Brazilians forget) and forced to face competition in their sectors. Nor do Brazilian politicians dare to voice the politically sensitive but economically sensible idea of reforming the directed credit system. Another force for distortion, the development bank BNDES, is almost universally popular among Brazilians despite the regressive nature of its financing, which takes money from the working class through the mandated payroll savings scheme and uses it primarily to finance Brazil's biggest corporations.

Productivity Growth and Innovation

¶12. (SBU) Even with low investment levels, Brazil could sustain higher growth rates were productivity growth higher. Brazil, however, spends only 1% of GDP on Research and Development (half the OECD average), and most of that is spent by government and universities, not the private sector. An "innovation law" passed in December 2004 aimed to improve the situation by promoting partnerships between universities and companies to develop technology. Total factor productivity, however, which can be used as a proxy for innovation in an economy, has made only marginal (and in some cases negative) contributions to Brazilian GDP growth over recent years, according to data from the OECD and IPEA. Another well-known obstacle to innovation and R&D in Brazil is spotty enforcement of Intellectual Property Rights (IPR). In a meeting with the Ambassador, Petrobras President Gabrielli implied a negative opinion of Brazilian IPR protection by emphasizing how important it was for Petrobras to obtain approval for its U.S. patent application in order to move ahead with investing in Brazilian production of H-Bio, a biofuel made by an innovative distilling/refining process using a blend of petroleum and plant-based oils (such as soybean oil).

¶13. (SBU) Finding adequate human capital is also a challenge for businesses in Brazil. As of 2004, the average Brazilian had attended school for 6.6 years and only 57% of students finished primary school. Given constitutional earmarks for education spending, the issue is less one of lack of money but of priorities. Brazil spends about 4.3% of GDP on education, a level equivalent to the OECD average. But the distribution is troublesome: Brazil spends about as much on primary education per student as Paraguay and much less than Mexico, Chile and Argentina. But it lavishes spending at the tertiary level, supporting an expensive system of free public universities, entry to which is governed by rigorous entry exams. Access to this system is limited as only the

better-off can afford the costly preparatory courses that most students find necessary to pass the entry exams; those public universities serve only 5.1% of the college-age population. President Lula has proposed incremental reforms to this system.

Trade -- Ideological Focus

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¶15. (SBU) One way to achieve greater productivity is through greater competition, including openness to trade. But the Brazilian economy is a relatively closed one, with imports accounting for about 10% of GDP as of 2006 (albeit trending upward). The average applied tariff of just over 10%, which is higher than OECD averages, also masks higher protection levels for certain sectors, particularly manufactures. Moreover, the foreign ministry's ideologically driven focus on furthering south-south cooperation in its trade negotiations has not helped Brazil significantly. A former finance ministry Under Secretary pointed out to the Ambassador recently that the several trade agreements Brazil (via the Mercosul Customs Union) had concluded during President Lula's first term covered countries accounting for only 3.6% of Mercosul exports and 1.2% of its imports. But even these tiny figures are overstatements of the accords' importance as most of them cover only a small fraction of tariff line items -- 10% in the case of the South Africa-Mercosul agreement and 5% in the case of the Mercosul-India agreement. The former Under Secretary confided that he was roundly attacked in the press by representatives of Brazil's influential Sao Paulo Industry Federation (FIESP) after presenting this trade data and argued that Brazil needed to pursue trade agreements with its major markets, such as the EU and U.S.

Headline reforms vs. smaller measures

¶16. (SBU) Even if prospects are bleak for headline reforms, there is much that smaller reforms can accomplish. For example, some of the growth in credit, and particularly the reduction in spreads for loans to individuals in recent years, is due to the creation of payroll-deduction loans, in which loans repayments are deducted directly from the borrowers' salary (or INSS pension payment). These loans gave banks greater security and led to more lending to individuals at lower cost. The IMF resrep believes much of this lending went to support expansion of small businesses by family members of the people who could get such loans. Another measure, the SIMPLES regime, lowered and unified taxes for small businesses (i.e. with revenues of up to 1.2 million Reais a year, or about USD 550,000). This allowed many small business to move out of informality, boosting formal employment (and tax revenue) despite the lower tax rates. Legislation to expand the program by increasing the revenue ceiling to 2.4 million Reais is close to final congressional passage. The Lula administration also passed targeted tax breaks, along with complementary regulatory adjustments, which together have helped spark a construction and real estate boom. But these smaller measures, however effective in accomplishing their focused goals, are typical Brazilian work-arounds (the culture of the "jeitinho"), and leave untouched the fundamental growth-limiting distortions in the Brazilian economy.

But little societal ferment

¶17. (SBU) Brazil's middling growth rates are simply insufficient to lift the masses out of poverty the way many Asian economies have. Lula's Bolsa Familia program, however, is now reaching over 11 million families, helping raise the living standards of the poorest. These income transfer programs do little to help recipients get jobs or become less dependent on handouts, but by conditioning the transfers on keeping children in school and their vaccinations updated, they aim to improve the next generation's prospects and break the intra-generational transmission of poverty. Transfer mechanisms such as Bolsa Familia and the income transfer portions of

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the social security system, which subsidizes pensions for elderly rural poor, are in part responsible for the improvement in Brazil's GINI coefficient (a measure of inequality) over the last two years. Brazil's economy has been creating record numbers of new formal sector jobs. Taken together, these factors take the edge off of social ferment that might otherwise result from lower growth levels.

¶18. (SBU) Comment: The political compromises that made possible the signal economic achievements of the Real Plan were forced through the political system by economic crises: hyperinflation, debt, recession and devaluation. With a sound macroeconomic framework and a largely market-based economy in place, however, Brazil today faces no serious threat of near term crisis. Although Lula's re-election has to an extent given him a renewed mandate, he has limited political capital with which to forge a coalition. Unfortunately, the most significant reforms, particularly in the areas of tax reform and fiscal federalism, will require constitutional amendments and congressional super-majorities. Absent the threat of economic crisis, Brazilian politicians, reflecting both prevailing societal preferences and their own interest in political self preservation, will err on the side of moderation in reforms, condemning Brazil to lower potential growth path into the medium term.

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